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# Tax planning

Frederick W. Bassinger



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# Tax Planning

by Frederick W. Bassinger
Principal, Minneapolis Office

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Tax planning should, in this modern day, be an important part of every business transaction. Taxes cannot be ignored, because only after-income-tax dollars are available to the businessman for his own purposes and pleasures. Further, if he doesn't spend all he makes during his lifetime his estate may be further dissipated by estate and inheritance taxes.

The first step necessary for any taxpayer to concern himself with is that of choosing his goal. Usually the taxpayer will be concerned with securing for himself the greatest after-tax proceeds possible. He must decide whether he wants as much cash as possible as soon as possible or is willing to defer some current benefits to secure perhaps even greater benefits at a future time. He must decide whether he wants to include his family in his financial plan and thus, considering the whole picture, to make it his goal to receive the greatest after-tax benefits available, including any gift, estate, and inheritance taxes to which he, his estate, or his heirs may be subject.

The usual situation lies somewhere between these two extremes. The taxpayer is usually willing to defer some of the fruits of his efforts if the tax savings so justify, and he is usually willing to divide some highly taxed wealth among other low-bracket members of his family—especially if in any event he contributes to their support. Perhaps he is very charitably minded and is seeking a way to contribute more to charity than is currently deductible. Perhaps certain members of his family have not met his standards or he feels more wealth in their hands would only stymie initiative.

Once he decides his basic objective, however, the taxpayer is then ready to proceed toward realizing these goals; to do this he must have the help of effective tax planning.

The opportunity to control the tax burden exists because of the alternatives the taxpayer has available. All possible courses of action must be analyzed and the tax consequences weighed before an intelligent decision can be made. By alternatives I mean not only making elections available under the Code—such as instalment reporting or writing off organization expenses—but such basic policy alternatives as types of employee compensation and benefits, and the choice of buying or leasing.

Alternatives face the business man before he ever opens the store doors. He must choose a form of business conducive to the achievement of his personal goals. If he expects losses in the early years and has other income, perhaps he should not choose to incorporate during the early period of the business formation. He could then charge these losses against ordinary personal income and later, when the business proves successful, incorporate to take advantage of the fixed corporate rate. At a later date the corporation may be liquidated, or sold, and the profits taken out at capital gains rates; or, the corporate earnings may be retained until death, thus enabling the stockholders to escape income taxes altogether. Of course, the fair market value of the stock will be subject to estate taxes; but here, too, choosing the right alternatives can result in tax avoidance.

I should differentiate the term tax avoidance from tax evasion. Tax avoidance is the legal action of the taxpayer to reduce his taxes by carefully choosing a course of conduct that complies with the language of the statute and its interpretations. Tax evasion implies an illegal effort to thwart the purpose of the law and is very much frowned upon by the government.

As soon as the 1913 tax law was passed the question of tax avoidance was raised and Justice Holmes of the United States Supreme Court in *Bullen* v. *Wisconsin*[1] held that tax avoidance was neither illicit, reprehensible, nor even mildly unethical.

In 1934 in *Gregory v. Helvering,*[2] Judge Learned Hand declared:

> a . . . transaction, otherwise within an exception of the tax law, does not lose its immunity, because it is actuated by a desire to avoid . . . taxation. Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes.

When Christianity was established as the official religion of the Roman Empire in the fourth century, priests were accorded favorable tax treatment. Needless to say, within a short period of time the term "priest" had to be defined, as by that time much of the Roman

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1 3 AFTR 2944 (S Ct 1916)
2 13 AFTR 806 (CA-2 1934)

citizenry had begun to fulfill their desire to convert their fellow man (at least for the purpose of Form X-XL).

As time passed and tax avoidance schemes became more and more popular, the courts have had to distinguish between "form" and "substance." If the basic elements and form are consistent, the form will prevail even though tax motivated. The old adage about "a rose by any other name" holds true in taxes; thus dividends are still dividends even though named interest. This would be true if a corporation were thinly capitalized with the thought of drawing out profits in the form of interest to avoid the double tax. This is still a good plan in certain circumstances but the secret is not to be greedy. The acid test, as spelled out in *Weiss* v. *Stearn*[3] is, "What was actually done?"

By far the easiest and simplest method of reducing the tax burden is for the tax rates to be lowered. In the eleventh century Lady Godiva did the people of Coventry a service by displaying equestrienne prowess. Since a modern-day version of this feat is probably not practicable we should consider acceptable alternatives.

The principal methods of avoiding taxes are to:

- Equalize income over the years to keep it out of high brackets;
- Divide income among several taxpayers;
- Grant fringe benefits;
- Create an equity in capital assets and at the same time deduct the expenditure for income tax purposes;
- Choose a course of action that will make a non-deductible expenditure deductible;
- Take full advantage of deductions, elections, and exclusions allowed by the law.

EQUALIZE INCOME OVER THE YEARS TO KEEP IT OUT OF HIGH BRACKETS

This is usually accomplished by accelerating or deferring income or expense. If, in this manner, a postponement of taxes can be effected it will allow the taxpayer rather than the government to have use of the tax money. I might add that this additional capital will be interest-free to the taxpayer. Sometimes this deferment will result in a permanent postponement.

Expenditures for research and development and for advertising can easily be accelerated or deferred and are excellent means of equal-

[3] 4 AFTR 3986 (S Ct 1924)

izing income. These expenditures will be discussed later under another caption.

Needed repairs can be made currently or deferred to a later period if the deduction would prove more beneficial.

A company can stock up on, or defer the purchase of, minor supplies that are not inventoried, as the purpose best suits them.

Disputed items are deductible only when settled; therefore if such settlement can be accelerated or deferred, the tax consequences of such action must be considered. If the settlement is deferred the additional cost of deferring the deduction must be weighed against the potential advantages to be gained.

Most companies offer some sort of cash or trade discount that may be tied in with their collection efforts. From strictly a tax standpoint it is better to sell at the after-discount price and charge interest for late payment than it is to give a discount for timely payment, because at year end a reserve for contingent discounts is not an allowable deduction.

A cash-basis taxpayer can control shipping dates and collection efforts to suit his equalization efforts but since an accrual-basis taxpayer usually has to recognize income when title passes, other steps are necessary. The closing of the sale should therefore be accelerated or deferred to suit the taxpayer's purpose.

Sales on consignment are not income until such time as the consignee resells or uses your merchandise; therefore, certain sales could be made on consignment if payment is not expected until the following taxable period and if deferral is desired. In any event, where you have certain customers that don't pay their accounts until they in turn make a resale, consignment sales should be considered from a tax standpoint. Such policy would, in effect, place these receivables on a cash basis.

In drafting sales agreements it should be remembered that option payments or escrow arrangements will suspend receipt of income until the option is exercised or the payment forfeited.

### DIVIDE INCOME AMONG SEVERAL TAXPAYERS

The use of multiple corporations, assuming operations are profitable, will result in a tax savings of up to $5,500 for each additional corporation used and will also insulate $100,000 accumulated earnings for each additional corporation from the unreasonably accumulated-earnings tax threat. However there has to be a business purpose for the additional corporations or they may be considered as one corporation for tax purposes.

A taxpayer who spreads his income among the several members of his family will pay a smaller tax bill than his fellow taxpayer with the same taxable income but who bears the burden himself.

Family partnerships and corporations are a common means of accomplishing this goal as are gifts of income-producing property and sales, at cost, of investments that have increased in value, to other members of the family.

The use of the ten-year trust should not be overlooked. The code specifically provides that if a trust is set up for at least ten years, or the life of the beneficiary, whichever is shorter, after which the principal may revert to the grantor, the income during the term of the trust is taxed to the trust or the beneficiary and not to the grantor. If a high-bracket individual is supporting an aged relative with after-tax dollars, he should consider a short-term trust and take advantage of his relative's lower bracket. For estate tax purposes, he may not want the principal to revert to himself but perhaps to his children or leap-frog to his grandchildren or even to charity. If a charity were to be the recipient, an immediate tax deduction for the present worth of the contribution would be allowable.

A favorite way to spread income among the members of the family, and to avoid or minimize estate taxes, is to incorporate or reorganize and give the children common stock while the parents retain preferred stock. Thus the increment in the stock passes to the children.

The use of the joint return automatically divides the income between husband and wife and is usually advantageous.

### GRANT FRINGE BENEFITS

Content and happy employees are an asset to any company. Their good morale is usually manifested by good work. One of the basic items contributing to this contentment is a sense of financial security.

Financial security comes about in many ways: by life insurance or health and accident insurance, or from a wage continuation plan wherein an employee knows that funds are coming in even though he is sick or injured.

Certain forms of financial security such as FICA, unemployment insurance, and workmen's compensation are forced on both the employer and employee. But these levies too contribute to his sense of financial security.

People don't spend their resources in the same manner or for the same things, but there are many common expenditures. One of the largest and most common of these is income taxes. Others include medical expenses, life insurance, and a savings program for the "golden years." However most of these expenditures have to be made out of after-tax dollars.

The employer who can provide these same items to an employee with before-tax dollars can obviously do so at a smaller cost. Whether or not the employer, in turn, passes all or part of this tax savings on to the employee is another matter. The fact remains that the employee's needs have been fulfilled and he is left in as good or better position than he was formerly—and at a savings to the employer!

It must also be pointed out that any employer who enters into a fringe-benefit program must make the benefits very clear to the employee or such expenditures will not accomplish their purpose. Many employees feel that take-home pay is the measure of their compensation. How many people do you know who have no idea what their federal income tax liability was last year? The majority of them can tell you right down to the penny the amount of their refund or additional liability on their return. They can also tell you to the penny the amount of their real estate taxes, even though this amount may be considerably less than their income tax. This is so because the income tax money doesn't pass through the employees' hands. This same lack of financial sophistication may also apply to fringe benefits.

An employer must weigh this lack of appreciation on the part of his employees against what is being accomplished. If he decides to grant fringe benefits he must also adopt a good public relations program to go with them. Some companies will value all fringe benefits and on the employees' payroll check stubs, show the gross pay as including such benefits, and then deduct for these benefits on the theory an employee's ego is more inflated if he feels he is making $200.00 per week and paying for his own benefits than if he is making $150.00 per week and receiving some other benefits of amounts unknown.

Many employers grant extensive fringe benefits to their executive employees only. Perhaps this is because the executive is more sophisticated in his views toward such matters as compensation and income taxes. After all, such sophistication is one of the reasons he is the executive. Another reason for fringe benefits to executives is that their salaries often put them in a high income tax bracket and it is difficult to pay them enough before-tax income to meet their after-tax needs.

Assuming a company decides to adopt a fringe-benefit program, what pattern should be adopted? Each employer will have to consider the needs of his particular employees in relation to the available benefits that he can afford. Some of the more common forms of benefits are:

*Group Life Insurance*

This benefit can be obtained at rather low cost and is deductible by the employer. The amount paid for the premiums is not taxable to the employee as additional compensation (unless the insurance is of a permanent type and is not forfeited by the employee when his employment is terminated), nor does the beneficiary pay income tax on the proceeds.

Life insurance on other than a group basis is still deductible by the employer if it represents additional reasonable compensation and if the employer is not directly or indirectly a beneficiary under the policy. Here the premiums constitute taxable income to the employee, thus making its benefits subordinate to group insurance.

*Split-dollar Life Insurance*

An executive is able to purchase more insurance by use of a split-dollar arrangement than he would presumably be able to carry otherwise. Under this procedure the company pays the portion of the premium equal to the increase in the cash surrender value and the executive pays only the excess portion. The executive gains because he presumably isn't charged interest on the money he borrows. The company's loan is protected because it is always entitled to the cash surrender value.

*Health and Accident Insurance*

Generally the benefits under a health and accident insurance plan, put into effect under sections 105 and 106 of the Internal Revenue Code, are not taxable to the executive and are deductible by the employer. This plan can cover not only the executive but also his wife and dependents. The plan need only cover one employee but may cover any number. The company may also reimburse an executive for premiums he paid for his own health and accident insurance.[4]

Benefits received from health and accident insurance may include compensation for loss of wages and payment for medical care or personal injuries. However, in the case of compensation for loss of wages during a period of sickness or injury the exclusion is limited to a maximum of $100 per week.

### *Wage Continuation Payments*

An executive can exclude payments up to $100.00 a week made by an employer under a wage continuation plan because of sickness or injury. However, the first seven days are not excludable unless the absence is due to injury or the executive is hospitalized at least one day during the period of absence.

### *Qualified Plans*

A pension, profit-sharing, or stock-bonus plan qualifying under section 401 of the Code or a restricted stock-option plan qualifying under section 421 of the Code offers unusually generous tax-saving opportunities.

A pension plan is designed to provide a livelihood, without regard to profits of the employer, for employees or their beneficiaries after the retirement of the employee. The plan may be trusteed or handled through an annuity contract.

A profit-sharing plan permits employees or their beneficiaries to share in the profits of the business in accordance with a definite formula for the allocation of contributions by the employer and for the subsequent distribution of these contributions and accumulated earnings.

A stock-bonus plan is similar to a profit-sharing plan except that benefits provided thereunder are distributable in corporate stock of the employer, and contributions are not necessarily dependent on the profits of the employer.

Under the qualified pension or profit-sharing plan the employer is entitled to an immediate deduction but the benefits to the employee are not subject to immediate taxation. These funds can then generate

[4] Rev. Rul. 61-146 (1961-32 IRB).

further income which is generally also immune from immediate tax. The benefits, when ultimately paid, continue to be accorded favorable treatment or may escape tax altogether. It is also possible for an employee voluntarily to elect to supplement his retirement fund[5] with after-tax dollars and the earnings on these after-tax dollars will also accumulate tax-free.

A qualified plan may accept voluntary contributions up to 10 per cent of an employee's compensation, or require a contribution of up to 6 per cent of his compensation, as a condition precedent to participation, or both.

It becomes apparent that when as much as 16 per cent of an employee's compensation is coupled with the contributions of the employer, a substantial amount of money becomes available for earning tax-deferred income. Recent statistics attest to the popularity of pension plans in that such plans presently cover approximately twenty million persons.

If an employer grants an option to an employee to purchase stock at a bargain price, the exercise of this option may result in immediate income unless the option qualifies as a restricted stock option. Income is realized when the employee gets an unconditional right to receive the stock. The income realized is the excess of the fair market value of the stock over the cost of the stock. If the option has a "readily ascertainable fair market value" income may be realized at the time the option is granted.

However, if an employee is granted a "restricted" stock option, he has no income either when he receives the option or when he exercises the option and acquires the stock. Of course the employer is not entitled to a deduction with respect to the stock transferred and only the price paid by the employee is considered as being received by the employer.

To be a qualified stock option plan the option must be granted by the corporation to the employee in connection with his employment for a price at least equal to 85 per cent of the value of the stock, and must include certain limitations on the exercise and disposition of the stock. The most important limitation is that the stock acquired by the employee when he exercised the option must be held by him until at least two years after he received the option and for at least six months after he acquired the stock. The six-month requirement has recently been a big disadvantage to some executives who exercised

[5] Rev. Rul. 59-185, 1959-ICB 86.

their options using margin funds shortly before the May market decline and were forced to sell to meet margin requirements. This untimely disposition may have disadvantageous tax results.

### *Other Fringe Benefits*

The executive dining room can create benefits for the employer as well as tax-free benefits for the executive. In most executive dining rooms a considerable amount of the conversation that takes place is about company affairs and this allows the executive to get more done during the normal work day. A lunchroom for the employees can also be provided.

Athletic and recreational facilities can be provided or sponsored.

Company picnics and office parties are usually long remembered.

Turkeys or hams at Christmas or Thanksgiving are low-cost items that help create employee good will.

Interest-free loans to executives or employees can be made.

Payments up to $5,025 made to the widow of a deceased employee are received income-tax free.

Courtesy discounts to employees is very common and help to ensure employee loyalty to the company product. Such a discount is not taxable income to the employee although he definitely receives an economic benefit.

## CREATE AN EQUITY IN CAPITAL ASSETS AND AT THE SAME TIME DEDUCT THE EXPENDITURES FOR INCOME TAX PURPOSES

This would include, but certainly not be limted to:

- Use of accelerated methods of depreciation
- Research and development
- Advertising
- Improved methods of operations
- Building a sales organization and new markets

Since these expenditures are deductible currently but benefit future periods as well they represent an excellent means of equalizing income, deferring taxes, or converting ordinary income into capital gains.

The opportunity to carryback operating losses and thus recover taxes paid in prior years also encourages these expenditures.

With income tax rates so high, many businesses are placing great emphasis on building capital values. This increase in value is not taxed until realized by sale and then at capital gain rates. It may escape income tax altogether if the stock is retained until death.

The promised tax reduction in 1963 can result in the advertising dollar's returning income that will be taxed in the future at a lower rate.

There is also the "Wall Street" benefit that accrues to owners of corporations doing considerable investing in advertising with before-tax dollars. With many stocks selling at fifteen or more times earnings, expenditures made in early years that build up income in later years, multiply such income by the applicable "times-earnings" rate—a benefit further sweetened by being realizable at capital gain rates through sale of the stock.

The same theory applies to research and development expenditures. The profitable corporation can keep only 48 per cent of its current income but it would pay no tax on taxable income reinvested in research and development until such expenditures produce further revenue. At the right time the corporation's potential can be sold at capital gain rates.

Of course it doesn't make sense to spend an advertising dollar unless you expect to recoup an additional dollar of revenue that you wouldn't have made had you not made the expenditure. Or does it? By careful analysis, we see that because of tax leverage it is possible for a corporation to gain by spending $1.00 of pre-tax income on advertising that will ultimately result in only 49 cents return, if that return can be withdrawn at capital gain rates (such as through increased value of stock). Even further benefits will accrue if this increment is realized by an income tax-free step-up in the basis by reason of death.

### CHOOSE A COURSE OF ACTION THAT WILL MAKE A NON-DEDUCTIBLE EXPENDITURE DEDUCTIBLE

An example of this procedure would be to rent land instead of purchasing it. The rental or leasing fee would naturally consider that the lessee doesn't obtain title and therefore the over-all expenditure would probably be less than the purchase price and would also be deductible currently. The agreement could also contemplate leasehold improvements that aren't taxable to the lessor as made or at the termination of the lease and are amortizable by the lessee. One must be careful, however, not to make these improvements in lieu of rent.

TAKE FULL ADVANTAGE OF DEDUCTIONS, ELECTIONS, AND EXCLUSIONS ALLOWED BY THE LAW

This would include such basic items as taking percentage depletion and the purchase of municipal bonds.

There is no need to choose the accrual method of accounting if the taxpayer can qualify for the cash method. Election to use a hybrid method of sorts can be very advantageous. Unless inventories are a factor there is no requirement to pay income tax on accounts receivable until the cash is realized. Of course this is not too practical for the large corporation but can be very useful to the smaller business man.

Over the past years, use of LIFO inventory has been an effective means of reducing taxable income. This will continue to be true as long as prices are rising.

A corporation that invests in domestic stocks receives favorable tax treatment on dividends because dividend income is taxed to a corporation at a maximum of 7.8 per cent (because of the 85 per cent dividends-received credit) while it may be taxed to an individual at as much as 87 per cent.

Tax planning is not limited to the businessman. The wage earner, through propitious use of the standard deduction, can make substantial tax savings. I have seen many individuals with a few dollars to invest, risk their hard-earned dollars for a five or ten per cent taxable return or leave it in the savings bank drawing taxable interest. If they would consider that there is available to them a 20 per cent or more, tax-free, government-guaranteed return on their investment I am sure there would be a change in many "portfolios." By taking the standard deduction in alternate years and prepaying or deferring contributions, interest, taxes, and other deductible items and by deferring payment of medical bills, the resulting tax savings can be the best investment the small investor can make.

## BUSINESS GROWTH AND DIVERSIFICATION

Most business men, by nature, desire to expand and perhaps diversify their operations. If they choose the acquisition route their job is easier because of tax factors. If the business they desire to acquire has an earning history, the present owners are likely to be subject to heavy taxes on any dividends they take out of the business. The prospective seller should also be made aware of the heavy estate tax liabilty that may be forthcoming unless he discovers the coveted fountain of youth (which, if further explored, would undoubtedly put him in a still higher bracket). If the business is sold the profits can be withdrawn at capital gain rates but if he is willing to take stock for his business he may be able to get marketable securities and not have to pay any tax until he disposes of these securities. Further, if he holds them until he dies, income tax thereon will be escaped forever. It is also possible that he can get further diversification by selling the assets of his business, converting it into an investment company, and then merging into a mutual fund.

Today's large corporations deal with different products and have separate operating branches or subsidiaries for manufacturing and distributing to different areas. The question of whether to set up separate branches or subsidiaries must be decided. Naturally the legal aspects must be considered but the tax considerations are also important. If divisions are chosen, losses of one branch may be offset against the gains of another and the tax on intercorporate dividends thus eliminated. Also the tax on the profits from sales between branches is eliminated. If subsidiaries are chosen, the surtax doesn't apply to the first $25,000 of taxable income of each subsidiary. This could represent an annual tax saving of up to $5,500 for each subsidiary.

If foreign operations are concerned, the use of a subsidiary corporation to qualify as a Western Hemisphere Corporation should be considered. Income earned by a foreign subsidiary, under certain circumstances, is not subject to U. S. tax until finally distributed, while income earned by a foreign branch is taxed immediately.

## WORDS OF WARNING

I am not sure if the lawyer who originally asked the question was from the I. R. S. office or not, but the reply "Render unto Caesar that which is Caesar's" has prima facie acquiescence from the Commissioner and still must be heeded. It is generally impossible to avoid taxes altogether and such attempt may have severe consequences if the plan fails. The best plan usually is one that legally reduces the tax to the lowest possible level. A taxpayer thinks twice about paying up to 91 per cent of potential profit in federal income taxes, plus state taxes. He may, however, feel 25 per cent is enough tribute to Caesar and still make the venture attractive.

## HOW CAN MANAGEMENT ASSURE ITSELF THAT IT IS TAKING FULL ADVANTAGE OF POTENTIAL TAX SAVINGS?

There is little doubt that there are great rewards to be had for advance planning but how can management assure itself that it is taking full advantage of potential tax savings? It would be quite spurious for any business man to state that he is definitely receiving the best possible tax results from such things as investment of idle funds, the borrowing of necessary funds, bad debts, inventories, sales policies, fringe benefits for employees, or leasing.

It is basic tax planning for management to instigate procedures whereby supervisors and lower-level management are oriented to the point of recognizing a tax problem or an opportunity to effect tax savings. Then steps should be taken to ensure that these problems or ideas are evaluated by a person competent to make such an evaluation. For the large corporation a separate tax department is usually the answer. For the smaller taxpayer an outside tax consultant may usually be more economical and practical. In any event a periodic review of all accounts and all major categories of transactions should be made to determine the alternative ways of handling the transactions. Such a review should show why the present handling is superior. I am sure that in most situations instances will be found where the tax advantage to be gained by using an alternative will be substantial.